AMP 17/11/2009 FAT-AUS-450

AMP AUD $6.35 Core MED. B

Dunn deal?

When a company launches a major acquisition, it is wise to consider their past form in this area. AMP's track record is far from glittering given their disastrous UK expansion and subsequent retreat just a few years ago. Nevertheless, its current bid for Axa AP's Australian and New Zealand business is an altogether more favourable proposition.

Should it succeed, the acquisition will be transformational for AMP in terms of market share gain. The company would become a leading provider of wealth management and protection products in Australia. This is a key reason behind CEO Craig Dunn's willingness to pay more for this set of assets than the Aviva business, for which NAB previously outbid them.

The table below shows the market share of AXA, AMP and the 4 major banks.

	AMP & AXA	NAB	AMP	CBA	WBC	ANZ	AXA
Retail superannuation	23.6%	19.3%	17.8%	13.5%	10.4%	9.5%	5.8%
Retirement income	17.6%	13.2%	11.4%	17.1%	10.2%	9.3%	6.2%
Retail managed funds	18.1%	15.5%	12.3%	13.5%	11.2%	8.4%	5.8%
Individual risk	20.1%	19.1%	10.9%	15.1%	6.8%	11.3%	9.2%

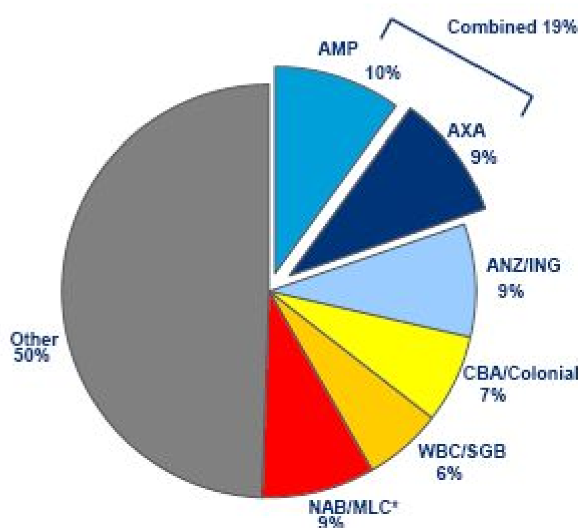
As the data shows, the AXA acquisition would see AMP dominate the sector's key product areas.

As we discussed in FAT449, the Australian wealth management industry is particularly attractive due to compulsory superannuation. This provides guaranteed growth due to the constant flow of funds to the sector. The under-penetration of life insurance products in Australia will also facilitate attractive growth in this area. Indeed, industry expectations are for the life insurance market to achieve 12.7% annual growth, to total sales of $22 billion through to 2017.

Importantly though, AMP is not just attempting to acquire market share. There is also considerable value in AXA's existing financial planner network. Financial planners are either "independent" or "aligned". The aligned variety effectively operate as a sales force, funnelling their clients' money into their aligned company's products.

While independent planners offer competing products, they also serve as a gateway for retail funds to the market. The bottom line is that the company with the largest number of gateways, all else being equal, should receive the largest volume of new business.

As shown in the chart below, the major providers currently hold a reasonably even share of the Australian financial planner network.



The AXA/AMP combination will dramatically change the competitive landscape, launching AMP's network size head and shoulders above its competitors. We would expect this factor to prove critical in allowing AMP to defend and even extend their post acquisition market leading position.

The caveat to this is the regulatory risk currently hanging over the sector. There are currently three government reviews underway. These are the Cooper review of superannuation, the Henry tax review and the Ripoll review.

The Ripoll review will report its findings on November 23, probably recommending changes to the way in which planners receive commissions. As the Storm Financial debacle ably demonstrates, commission based remuneration structures are not necessarily in consumers' best interest.

The Cooper review will run into next year. The review's mandate is to examine the governance, efficiency, structure and operation of the superannuation industry. While the exact outcome is anyone's guess, the broad result is likely to be reduced costs to the consumer and reduced revenues to the industry.

One could argue that AMP's increased post-merger size leaves them with a greater exposure to regulatory uncertainty. While this is true, the industry is all about scale and volume. Greater volume leads to greater efficiency, which supports margin expansion and therefore leaves a given company better able to absorb a potential reduction to industry revenue.

Certainly in terms of planner commission payments, AMP is already moving towards a fee for service model. Management will roll out this change by June 2010, thereby buffering AMP from the shock of enforced regulatory change.

Prospects for a higher offer

Returning to AMP's offer for AXA (see FAT449 for details), an acquisition's value always comes down to price. On AMP's numbers at the time of the announcement this equates to about 16.6 times Axa AP's forecast 2010 earnings. This is not startlingly cheap in absolute terms. However, earnings are currently at a cyclical low and realisation of synergies will provide a further boost in the years ahead.

Axa AP's Chairman Rick Allert has made it quite clear that he feels the offer undervalues the company. Given that some two thirds of the payment would be in the form of AMP stock, AMP's subsequently buoyant share price has weakened Mr Allert's argument. In light of which, AMP may feel that it can bring Axa AP to the negotiating table without improving the terms of the bid.

If an increase is forthcoming, it will likely be in the cash component. Issuing more stock would dilute AMP's earnings per share and jeopardise management's claim of marginal earnings accretion in the second year.

Axa's parent company, Axa SA recently announced a 2 billion euro rights issue. Management stated that the funds are for acquisition opportunities. Given that Axa SA requires only around 1.1 billion euros to complete the Axa AP deal, they certainly have the capacity to throw in a cash sweetener to get the deal over the line. Given AMP's share price strength since the deal's announcement, this would not necessarily have to be particularly large.

Moreover, Mr Allert's rejection comments did reference the Asian assets' growth potential, which he feels the bid undervalues. This may allow Craig Dunn to elicit a higher price for the Asian assets from AXA SA, rather than lumping AMP shareholders with the cost of upping the offer.

What about the banks?

There is little doubt in our mind that the Axa deal makes excellent strategic sense for AMP. It also serves as a handy defence against one of the banks potentially moving on AMP themselves.

Australian bank acquisition targets are all but non-existent for the big four, with wealth management and insurance an attractive alternative. An acquisition of AMP represents a unique opportunity for the banks to build significant scale in the sector.

Moreover, should the Axa AP deal go through, the banks will find themselves at a competitive disadvantage due to their smaller scale relative to the Axa/AMP combination. This may prompt one of the banks to spoil the party before AMP becomes a little too large to swallow.

Given that CBA and NAB's sizable existing sector presence would be of greater concern to the ACCC, Westpac and ANZ are probably the more likely candidates. Westpac is however still digesting St George and

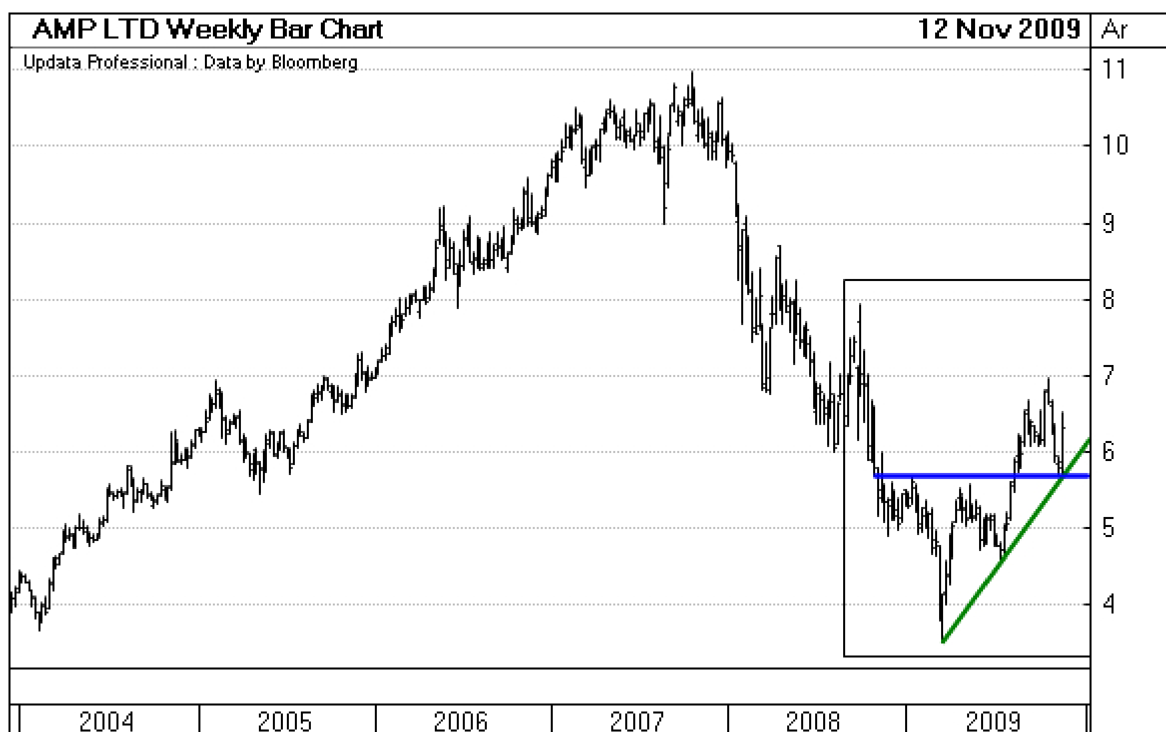
taking on AMP could result in indigestion. We therefore consider ANZ as the most likely of the big four to make a play for AMP.

ANZ's acquisition focus is biased to Asia, but preventing AMP from taking control of the wealth management/protection sector (while giving ANZ a significant leg up) may prove too tempting for CEO Mike Smith.

From a valuation perspective, AMP currently trades on a price to earnings multiple of 16.8 times consensus 2010 earnings and a prospective 4.7% dividend yield. This improves to around 13.7 times 2012 earnings, with the dividend yield rising to almost 6%.

Turning to the charts, there has been an encouraging improvement to the outlook for AMP over the past three months. As evident on the daily chart, prices broke above key resistance at $5.69 in August, which marked the upper boundary of a nine-month basing pattern. In our opinion, this suggests a significant low is now in place.

More recently, after rallying as high as $6.97 in October, the stock has corrected lower, before rebounding strongly over the past week. With previous resistance at $5.67 now offering support, we believe downside risks are limited and AMP offers solid upside potential over the coming months.



In summary, if AMP succeeds in acquiring AXA AP it will greatly enhance the company's exposure to the sector's relatively low risk, yet attractive future growth. Should Axa AP slip through their fingers, there is a reasonable chance that a major bank will make a play for AMP. Given these factors and AMP's current exposure to the sector's favourable characteristics, we recommend Members buy AMP around $6.35.

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Snapshot AMP

AMP

Reuters: AMP Limited (AMP) is a wealth management company operating in Australia and New Zealand. The Company has selective investment management activities in Asia. AMP has over three million customers in Australia and New Zealand. The Company has two core businesses: AMP Financial Services, which provides financial planning, investment services, superannuation, mortgage and savings products and life insurance products, and AMP Capital Investors, which provides investment management services, including private capital, infrastructure and property portfolios and socially responsible investments.

Market Capitalisation:$13bn

	FY1	FY2
Price to Earnings	16.8	14.7
Dividend Yield (%)	4.7%	5.4%
Price to Book	5.1	4.6
Return on Equity (%)	32.7	33.1

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